Office - Supreme Court, U. S.
FILED
OCT 28 1955
HAROLD B. WILLEY, Clerk

No. 373.

In the Supreme Court of the United States.

OCTOBER TERM, 1955.

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,
v.
PHILIP J. LoBUE,
Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Third Circuit.

BRIEF FOR THE RESPONDENT IN OPPOSITION.

MELVILLE F. WESTON,
RICHARD F. BARRETT,
H. AVERY RAFUSE,
30 Federal Street,
Boston 10, Mass.,
Counsel for Respondent.

Of Counsel:
POWERS & HALL,
30 Federal Street,
Boston 10, Mass.

ADDISON C. GETCHELL & SON, INC., LAW PRINTERS, BOSTON.

In the Supreme Court of the United States.

October Term, 1955.

No. 373.

Commissioner of Internal Revenue,
Petitioner,
v.
Philip J. LoBue,
Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Third Circuit.

BRIEF FOR THE RESPONDENT IN OPPOSITION.

Opinions Below.

The opinion of the Tax Court (R. 51a-59a) is reported at 22 T.C. 440. The opinion of the Court of Appeals is reported at 223 Fed. 2d 367.

Jurisdiction.

The jurisdictional requisites are adequately set forth in the Petition at p. 1. The time for filing this Brief in Opposition has been extended by Order of the Court to November 1, 1955.

Question Presented.

Where an employee is given an option to buy stock in his employer-corporation, with no intention on the part of the corporation thereby to compensate the employee but solely to permit him to acquire a proprietary interest in the corporation, does a purchase of stock at a price less than market value, pursuant to such option, result in taxable income to the employee?

Statutes and Regulations Involved.

The Statute, 26 U.S.C. 22(a), and Regulations, Regs. 111, Section 29.22(a)-1 and Section 29.22(a)-1 [as amended by T.D. 5507], involved are set forth in the Petition at pp. 2, 3 and 4.

Statement.

The facts of the case are adequately summarized in the Petition at pp. 5 through 9 with the exception of the Petitioner's omission of the major fact found by the Tax Court and relied upon by the Third Circuit, that there was no intention on the part of the employer to compensate the taxpayer (Appendix p. 26). An important element of the reasoning of the Third Circuit omitted by the Petitioner is that there must be no intention to compensate the taxpayer (Pet. pp. 8-9).

Argument.

It is submitted that the petition for a writ of certiorari should be denied for the following reasons:

1. This case is of no serious consequence to the Federal revenue. Stock option plans were *de minimis* until the enactment of the "restricted" stock option provisions contained in Section 218 of the Revenue Act of 1950, c. 994, 64 STAT. 906, Section 130A of the Internal Revenue Code of 1939, now Section 421 of the Internal Revenue Code of 1954,

whereby Congress evidenced its intention to allow employees to exercise compensatory options to buy stock in their corporations without being subjected to a tax upon the exercise if certain fixed requirements were met. This favorable legislation made "unrestricted" stock options, such as involved in the present proceedings, of even more minimal significance than before. Statistics show that there were very few stock option plans prior to 1950 and that since that time the great majority of such plans are intended to qualify as restricted options under Section 130A of the 1939 Code, now Section 421 of the 1954 Code. In a Report of a Special Panel to the Salary Stabilization Board dated October 23, 1951, entitled "Stock Option and Stock Option Plans", Item ES 4.2: St 6, it is stated at p. 8:

> ". . . It is clear, however, that the major part of the plans conceived after the enactment of Sec. 130-A in 1950 have been intended to qualify as 'restricted stock options' as defined therein."

In a letter dated July 31, 1951 from the New York Stock Exchange to the Panel, also at p. 8 of the above Report, the Exchange pointed out that stock option plans reported to it in the first six months of 1951 numbered 99 as compared to only 12 for the entire year 1948 and stated:

> "In recent months, most of the plans coming to the attention of the Exchange have been set up as restricted ownership or option under the terms of the amendments to the 1950 tax law."

The Articles cited by the Petitioner do not support its position that this case is of grave importance to the Federal revenue. In fact, quotations taken from these same Articles show that the authors believe that unrestricted stock options, the kind involved in the present proceedings, are no longer important and that it is the "restricted" stock option which is in the ascendency.

(1) *Leake,* "Compensating Executives And The Latest In Stock Options," 32 Taxes 488 (June 1954), states:

> "In the 1950 Revenue Act Congress eased, in a measure, the problem of compensating executive personnel by enactment of Section 130A of the Code, providing for so-called restricted stock options. There was agitation for this remedial legislation as a result of the decision of the Supreme Court in the *Smith* case, and more particularly because of the Commissioner's broad interpretation of that decision, *which led to the virtual abandonment of stock options as a common method of compensating employees.*" (Emphasis supplied.)

(2) *Stryker,* "Do Stock Options Pay," Fortune, December, 1954, p. 118, states:

> "Since 1950 nearly 400 sizable companies—approximately one out of every three listed on the New York Stock Exchange—have offered stock option plans to employees. The great majority of these offers have been of a new type known as 'restricted' options."

(3) "Option Opulence," Wall Street Journal, February 1, 1955, p. 1, states:

> "in the past five years, nearly 500 major companies have granted employees options to purchase stock. . . .
>
> "Congress, in passing the 1950 Revenue Act, opened the gates for the big stock option rush."

(4) *Lyon,* "Capital Gains Benefits Connected With Executive Retirement," Twelfth Annual N.Y.U. Institute on Federal Taxation, p. 365 (1954) at p. 377 states:

> "Beginning almost at once after Section 130A became law, in September 1950, statutory 'restricted' stock options began to be granted on a substantial scale by many major corporations. The extent to which this has taken place is indicated by a number of statistical studies and analyses, including the comprehensive hearings and report of a Special Panel which in late 1951 advised the Salary Stabilization Board on proper rules for treatment of options for stabilization purposes."

(5) *Lasser,* "How To Raise The Take-Home Pay of High-Priced Help Under Today's Wage Freeze And Tax Laws," 93 Journal of Accountancy 166 (Feb. 1952) pp. 171 and 172 states:

> "Stock options are the favorite gimmick just now. . . .
>
> "The rush started in October, 1950, when Congress changed the tax law. In effect, it took stock options out of the ordinary income-tax section, wrapped restrictions around them, and for tax purposes made them capital gains. Hence, the flood of new proposals. . . .
>
> "Most companies today use the 95 per cent options. Many give no bargain rates at all, merely set the price at the market."

(6) *Lloyd,* "Relations Between The Corporation And Its Officers And Employees," 30 Taxes 546 (July 1952) p. 550 states:

> "The period of gestation for stock options proved to be relatively short. The Revenue Act of 1950 was signed by the President on September 23, 1950. Within a period of less than nine months (to July, 1951) more than 75 major corporations had adopted option plans making available more than $400,000,000 in common stock to the officers and employees."

It is noteworthy that, in presenting his undocumented argument as to the serious consequences to the revenue, the Petitioner is silent as to "unrestricted" stock option cases pending before the Internal Revenue Service. The presumption is that there are few, if any. The Tax Court docket as of October 13, 1955, as reported by Commerce Clearing House, shows one employee stock option case pending before such court. CCH Tax Court Reporter, pp. 5901 et seq. (Docket No. 57815).

2. There is no conflict between decisions of the Courts of Appeals. On the contrary, the decision below is in harmony with decisions in similar cases by a number of other

Courts of Appeals. Each decision has turned largely on the facts of the particular case (see Appendix pp. 23, 24, fns. 4 and 5).

3. There is no conflict between the decision below and decisions of this Court. It is not understood that Petitioner claims there is. However, Petitioner claims that there is a conflict in principle between the decision below and decisions of this Court. Petitioner's argument is premised largely on the assumption that the mere exercise of the stock option and the derivation of any economic benefit therefrom resulted in the realization of taxable gain. This merely begs the question.

The Petitioner cites *Commissioner* v. *Glenshaw Glass Co.*, 348 U.S. 426, as authority for his conflict in principle argument. According to the Petitioner, this Court in the *Glenshaw* case established the principle that income as defined in Section 22(a) includes all advantageous purchases of property. The Court did not, of course, so hold and such a principle would be completely contrary to basic and long-acknowledged fundamentals of taxation. *Palmer* v. *United States*, 302 U.S. 63. In the *Palmer* case, the favorable exercise of an option to purchase stock in the optioner-corporation was held not to constitute a dividend to the optionee-stockholder, since, in the absence of an intent to pay a dividend, the transaction was merely a non-taxable purchase. *Mayer* v. *Commissioner*, 302 U.S. 647. Inconsistent with his position in the present proceedings, the Petitioner has officially adopted this principle in his regulations:

* * *

> "(b) If property is transferred by a corporation to a shareholder, for an amount less than its fair market value, regardless of whether the transfer is in the form of a sale or exchange, such shareholder shall include in gross income the difference between the amount paid for the property and the amount of its fair market value *to the extent that such difference is*

in the nature of a distribution of earnings or profits taxable as a dividend.'' (Emphasis supplied.) Regs. 118, Sec. 39.22(a)-1.

The above regulations are inconsistent in principle with those covering the companion employee-purchase situation. By the terms of the latter regulations *every* favorable purchase by an employee is *per se* and without exception compensation for services even though not intended as such. But the Petitioner has been consistently inconsistent. For seven years until 1946, the Petitioner and his regulations were in accord with the courts as to the effect of employee stock options. In 1946, following *Commissioner* v. *Smith,* 324 U.S. 177, and citing the case, he amended his regulations to read as at present (Appendix pp. 22-23). Now, in the present proceedings, the Petitioner has abandoned the *Smith* case as authority for his position (Appendix pp. 22-23) and does not cite the case in his Petition.

The Petitioner asks the Court to uphold his regulations as reasonable and consistent with the statute (Pet. pp. 12-13). At the same time, he illustrates the invalidity of the unconditional rule of the regulations by his admission that gifts by the employer represent one exception.

The Tax Court found as a fact that the employer's intent was to ''give'' the taxpayer a proprietary interest and not to compensate him for services. The purchase of stock thereby was unrelated to ''income derived from salaries, wages or compensation for personal services'' under the language of Section 22(a) and was simply an advantageous purchase opportunity given the taxpayer by his employer.

The Petitioner's economic benefit argument is also inconsistent with his treatment of other employee items, such as group life insurance and board and lodging. Regs. 118, Sec. 29.22(a)-3.

4. The Petitioner argues that the decision of the Court of Appeals (which is merely another decision in a virtually unbroken line of cases, see Pet. p. 20, fn. 1) will frustrate the purpose of Congress in enacting the "restricted" stock option provisions contained in Section 130A of the Internal Revenue Code of 1939, now Section 421 of the Internal Revenue Code of 1954. This is refuted by the fact that practically all of the stock option plans being instituted today are intended to qualify as "restricted" option plans, *supra*, pp. 3, 4 and 5, and by the clear statement of Congress of its intention that unrestricted options continue to be taxed "as under existing law." Senate Finance Committee Report 2375 (81st Cong. 2d Sess.) 1950-2 Int. Rev. Cum. Bull. 483, 526, 552.

As demonstrated above, unrestricted stock options are *de minimis* in significance and the present case arises in a setting which is now largely obsolete, and has been so for over five years.

Conclusion.

For the foregoing reasons, it is submitted that the petition for a writ of certiorari should be denied.

Respectfully submitted,

MELVILLE F. WESTON,
RICHARD F. BARRETT,
H. AVERY RAFUSE,
30 Federal Street,
Boston 10, Mass.,
Counsel for Respondent.

Of Counsel:
POWERS & HALL,
30 Federal Street,
Boston 10, Mass.